The Manufacturers Hanover
Economic Report

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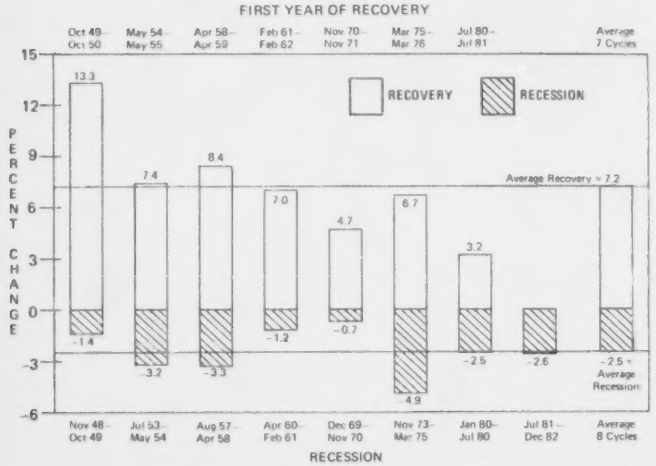
Business Conditions Update

The up-and-down U.S. economy appears to be expanding once again following the fourth quarter's decline. Unlike previous rises in economic activity, however, this one has the potential for lasting at least through 1983 (see table inside). If it does, it would mark the first instance of four consecutive quarterly increases in the real GNP since 1978. That would probably enable the National Bureau of Economic Research, the umpire of the business cycle, to declare that the recession which began in July 1981, has ended, and that a new expansion is underway.

Lower Interest Rates . . .

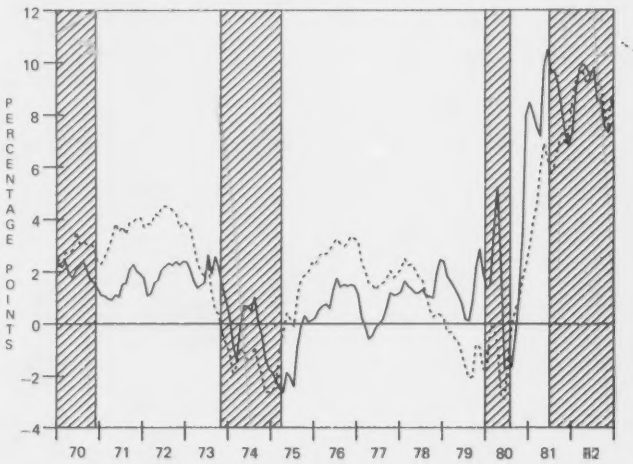
This assessment of the state of business is based largely on developments that have *already* occurred, rather than a forecast of what *might* happen. First of all, interest rates have fallen significantly. The banks' prime lending rate has dropped from 16½ percent to 11 percent, while rates on six-month commercial paper are down from about 14 percent to eight percent. In the longer-term area, interest rates on high-quality corporate bonds have fallen approximately three percentage points, while rates on home mortgages are down nearly four percentage points.

CHART I
CHANGES IN REAL GNP IN CYCLICAL PERSPECTIVE



These lower interest rates have revived two of our key industries. After touching a 20-year low selling rate of four million units during the month of June, new domestic cars today are selling at rates above six million—a 50 percent improvement in eight months' time. New home construction has perked up as well; the annual rate of new private housing starts is nearly double yearend 1981's level. Although homebuilding and automobiles do not bulk as large in the U.S. economy today as they did in the past, they are still important enough to have caused a ripple effect throughout the economy.

CHART II
REAL PRIME RATE (LINE)
VS. REAL AA UTILITY RATE (DOT)



You can see this improvement in the nation's basic industries. Output of lumber, paperboard, and steel has been rising for some time, now. Lumber is up 16 percent, paperboard 11 percent and steel 45 percent from their respective lows plumbed in 1982. Reflecting an improved balance between supplies and demand, most basic commodities' prices started to climb several months ago and, as a group, are back to their levels of last fall. Recently, construction contract awards hit a three-year high, while new orders for durable goods have climbed, too. January's drop in unemployment and rise in payroll employment may be a sign that the labor markets have begun to feel the effects of this turnaround as well.

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This pickup in activity, coming on the heels of earlier cuts in production, led to a massive inventory correction in 1982's fourth quarter. While real final sales were rising at a healthy 3.1 percent annual rate, the highest rate of growth since first-quarter 1981, inventories were being liquidated at the fastest pace in history. During the fourth quarter real inventories fell by $17.7 billion, pulling down the overall gross national product by an annual rate of 2.5 percent.

Because of this massive liquidation, shortages began to appear in many lines—not the least of which were automobiles, where supplies sank to a 12-year low in December. As a result, production of cars and many other items increased in January, and are scheduled to rise further in February. This leads me to suspect that this most recent phase of inventory liquidation is just about over. Such a development alone will give a lift to the economy during the first quarter of 1983. If final sales do no more than hold at their fourth quarter level, an end to inventory liquidation would lift the real GNP in the current quarter by about five percent at annual rates.

Some analysts, viewing such numbers, might be tempted to mark up their forecasts for the balance of the year. Even now, many suspect that, in forecasting a weak recovery, they may be underestimating the latent strength in the economy. To be sure, there is every reason for optimism. January's gain in industrial production was the second largest monthly rise in over two years. Further gains seem likely. The protracted slump has undoubtedly produced a great deal of pent-up demands for such key items as cars, houses, and goods for business use. The consumer could surprise us by lifting his spending rates faster than many now anticipate. This would frustrate producers' efforts to rebuild inventories, and cause an even steeper upturn in production in the months ahead. Other positive developments which could produce a better-than-expected recovery include the continued efforts by the Federal Reserve to depress interest rates and ensure an adequate supply of liquidity for the economy, as well as the recent softening in oil prices.

. . . Plus Lower Oil Prices . . .

A lot has been written lately about the impact of falling oil prices—most of it incorrect. While there are no doubt some losers, there are far and away more winners as the price of oil heads down. At the country level, you should remember that there are many more who import oil than export it. A large number of these oil importers are developing countries, whose own export prices have declined significantly as oil shot up. As the January, 1983 Economic Report observed: "Prices of the goods that developing countries export must return to their proper position relative to other prices *especially oil*, if these countries are ever to reduce their debts to more manageable proportions." Lower oil prices represent the first (non-inflationary) step in this direction.

In the U.S., lower oil prices will lead to faster economic growth. We calculate that each dollar per barrel decline in oil prices could, in time, lead to 0.2 percent more growth in the real GNP. As people find that their energy budgets go further, they will have more to spend on other goods and services. This, in turn, will expand production, leading to increased needs for workers, materials and machinery, etc. Eventually our appetite for imports would increase, thus benefiting our trading partners.

Lower oil prices will cut inflation, too. As you saw from January's producer price index, which fell by the most for any month in the postwar era, a drop in energy prices has a powerful effect on the overall price level. At the consumer level, we would expect each dollar per barrel drop in the price of oil to slow inflation by 0.2 percent. Interest rates will be lower, too; long-term rates could fall by over ten basis points per dollar decline in oil. Unemployment will be lower, while incomes, business earnings—and Federal tax revenues—will be greater.

On the other hand, some of the reasons offered for optimism don't seem to make much sense. For one thing, the notion that a severe recession tends to be followed by a vigorous recovery just does not hold up, when examined statistically. As you can see from Chart I, there have only been four cycles out of the past seven in which there was a relationship between severity of recession and strength of recovery. That is to say—a worse-than-average recession would lead to a better-than-average rebound and vice-versa. Then there are those who believe that there is a systematic relationship between the rate of growth in the money supply and the subsequent behavior of the economy. Since the money supply in the last half of 1982 expanded at annual rate of nearly 15 percent, those who follow this credo also look for strong growth in 1983. However, these are the same folks who, after watching the money supply jump by an annual rate of eight percent between December 1981 and June 1982, thought the economy would rise sharply in second-half 1982!

At the other end of the spectrum are those who feel that the upswing is so fragile that it is bound to be snuffed out in short order. They point to such factors as real interest rates, which, although down from their half-century peaks, are still high when compared with historical experience (Chart II). This makes it very costly for business to borrow, thus step up spending enough on plants and equipment to perpetuate the upswing much beyond the initial kick it will get from the end of inventory liquidation.

The pessimists assert that real interest rates are unlikely to come down appreciably for several reasons. For one thing, the Federal Reserve may soon run out of elbow room to push down nominal rates, since the recent uptick in long-term interest rates suggests that some financial market participants are becoming concerned over the prospects for renewed inflation. Short-term rates may remain high because the demand for money by the private sector will increase as a byproduct of the faster pace of economic activity, while the government's need for funds to finance its enormous budget deficits increases, too. Some think that the continued high rate of unemployment will drain consumer confidence, while others suggest that the marked slowing of inflation may induce people to hold off buying postponable goods, waiting for lower prices. Internationally, there is no shortage of problems, ranging from concern over debt burdens of various countries, to the growth of protectionism and the effects of the overvalued dollar on the ability of U.S. businessmen to market their goods abroad.

. . . Equals Economic Recovery

As you probably have determined by now, I think the most likely course of activity in 1983 will be midway between the path projected by optimists and that expected by the pessimists. The important point to remember, however, is that virtually every economist both in and out of government expects that 1983 will be a much better year than 1982. Indeed, most think it will be the best year for the economy in four years with nearly every region and sector posting at least some increase by yearend.

Of course, the stronger the rebound the more momentum it will have to carry it into 1984. And by producing more tax revenues for Washington, a stronger recovery would lessen the chances that Washington's huge deficits will cause renewed problems down the road for the U.S. economy, either in the form of higher inflation, another recession, or both. But it wouldn't eliminate these threats: The more the Federal budget deficit is trimmed this year, the better I will feel about next year and the years to come. M

February, 1983
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1982				YEAR 1982		1983				YEAR 1983	
	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2995.5	3045.2	3088.2	3101.3	**3057.5**	**4.1**	3168.1	3204.1	3273.9	3346.2	**3248.1**	**6.2**
GNP: $72	1470.7	1478.4	1481.1	1471.7	**1475.5**	**−1.8**	1490.6	1498.4	1515.3	1533.2	**1509.4**	**2.3**
% Change, Annual Rates	−5.1	2.1	0.7	−2.5	**−1.8**		5.2	2.1	4.6	4.8	**2.3**	
Consumption	1919.4	1947.8	1986.3	2034.6	**1972.0**	**7.0**	2060.5	2087.5	2130.3	2170.3	**2112.2**	**7.1**
Durables	237.9	240.7	240.3	251.7	**242.7**	**3.5**	251.2	257.8	266.6	272.8	**262.1**	**8.0**
Non-Durables	749.1	755.0	768.4	778.3	**762.7**	**3.8**	782.9	786.9	795.1	803.6	**792.1**	**3.9**
Services	932.4	952.1	977.6	1004.5	**966.6**	**10.6**	1026.5	1042.9	1068.5	1093.9	**1058.0**	**9.4**
Investment	414.8	431.5	443.3	397.9	**421.9**	**−10.5**	435.6	443.4	466.0	481.0	**456.5**	**8.2**
Non-Residential	357.0	352.2	344.2	336.6	**347.5**	**0.4**	322.9	319.1	324.6	331.0	**324.4**	**−6.6**
Producers Durable Equipment	215.6	208.6	203.0	196.2	**205.8**	**−4.9**	192.0	193.0	198.8	205.2	**197.2**	**−4.2**
Structures	141.4	143.6	141.3	140.4	**141.7**	**9.2**	130.9	126.1	125.8	125.8	**127.1**	**−10.3**
Residential	93.4	95.5	94.3	99.8	**95.8**	**−8.8**	112.0	119.3	127.7	133.9	**123.2**	**28.7**
Inventory Changes	−35.6	−16.2	4.7	−38.5	**−21.4**		0.7	5.0	13.7	16.1	**8.9**	
Net Exports	31.3	34.9	6.9	−6.9	**16.6**		−10.7	−14.2	−18.9	−19.1	**−15.7**	
Government Purchases	630.1	630.9	651.7	675.7	**647.1**	**8.4**	682.7	687.4	696.5	713.9	**695.1**	**7.4**
Federal Defense	166.2	176.2	182.7	188.9	**178.5**	**16.1**	192.5	196.6	202.8	210.8	**200.7**	**12.4**
Federal Civilian	83.5	68.2	76.3	87.2	**78.8**	**4.8**	87.1	84.2	83.1	87.6	**85.5**	**8.5**
State & Local	380.4	386.6	392.7	399.6	**389.8**	**5.9**	403.1	406.5	410.7	415.6	**409.0**	**4.9**
Final Sales: $72	1486.1	1482.7	1477.8	1489.3	**1484.0**	**−0.6**	1490.6	1496.4	1509.7	1526.8	**1505.9**	**1.5**
% Change, Annual Rates	0.2	−0.9	−1.3	3.1	**−0.6**		0.3	1.6	3.6	4.6	**1.5**	
GNP Price Index (1972 = 100)	203.7	206.0	208.5	210.7	**207.2**	**6.0**	212.5	213.8	216.1	218.2	**215.2**	**3.8**
% Change, Annual Rates	4.3	4.6	5.0	4.3	**6.0**		3.5	2.5	4.2	4.1	**3.8**	
PCE Deflator (1972 = 100)	202.2	204.0	207.7	210.2	**206.0**	**5.9**	211.9	213.5	215.9	217.9	**214.8**	**4.3**
% Change, Annual Rates	4.9	3.6	7.5	4.9	**5.9**		3.2	3.1	4.6	3.9	**4.3**	
Consumer Price Index (1967 = 100)	283.6	286.8	292.1	294.0	**289.1**	**6.1**	296.5	298.9	301.9	304.8	**300.5**	**3.9**
% Change, Annual Rates	3.2	4.6	7.6	2.6	**6.1**		3.5	3.3	4.0	4.0	**3.9**	
Total Personal Income	2510.4	2552.5	2592.4	2623.0	**2569.6**	**6.4**	2656.3	2678.3	2743.9	2801.9	**2720.1**	**5.9**
Disposable Personal Income	2117.1	2151.5	2198.1	2223.5	**2172.6**	**7.1**	2249.0	2270.1	2341.5	2390.8	**2312.8**	**6.5**
Savings Rate	6.6	6.7	6.9	5.8	**6.5**		5.7	5.3	6.3	6.5	**5.9**	
Employment Rate	56.6	56.4	56.2	55.8	**56.2**		55.6	55.8	56.0	56.3	**55.9**	
Unemployment Rate	8.8	9.4	10.0	10.7	**9.7**		10.5	10.3	10.0	9.8	**10.2**	
Indus. Production (1967 = 100)	141.8	139.4	138.2	135.1	**138.6**	**−8.1**	137.3	139.6	142.5	145.9	**141.3**	**2.0**
Housing Starts (000)	920.3	952.0	1118.3	1250.7	**1060.3**	**−3.6**	1358.0	1460.5	1524.9	1544.8	**1472.0**	**38.8**
Domestic Auto Sales (000)	5733.3	5466.7	5504.3	6133.3	**5709.4**	**−8.2**	6166.5	6402.3	6670.5	6828.0	**6516.8**	**14.1**
Corporate Pre-Tax Profits	171.6	171.7	180.3	180.6	**176.1**	**−24.1**	193.5	194.5	194.9	204.9	**197.0**	**11.9**
− Taxes	56.7	55.3	60.9	60.2	**58.3**	**−28.2**	65.9	66.3	65.9	69.7	**67.0**	**14.9**
Net Profits	115.0	116.3	119.4	120.4	**117.8**	**−21.9**	127.6	128.2	129.0	135.3	**130.0**	**10.4**
− Dividend Payments	68.8	69.3	70.5	72.4	**70.3**	**7.9**	73.7	75.0	76.3	77.7	**75.7**	**7.7**
Undistributed Profits	46.1	47.0	48.8	48.0	**47.5**	**−44.7**	53.9	53.2	52.7	57.6	**54.3**	**14.5**
+ Depreciation	208.8	216.5	223.7	231.9	**220.2**	**16.3**	240.5	247.6	254.7	261.3	**251.0**	**14.0**
− Inventory Profits	4.4	9.4	10.3	13.4	**9.4**	**−61.9**	8.9	7.1	9.7	10.4	**9.0**	**−3.7**
Net Cash Flow	250.5	254.1	262.2	266.5	**258.3**	**3.1**	285.4	293.8	297.7	308.5	**296.3**	**14.7**

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Why Interest Rates Are High

Bankers must be very responsible people. For whenever anything goes wrong in the economy—we seem to be responsible. Don't take my word for it, ask Treasury Secretary Donald T. Regan. He said last month that the banks were responsible for high interest rates: "I think that banks, faced with a lot of problem loans, both domestic and international, are doing their utmost to keep their earnings up by keeping their interest rates up." This was followed by several articles in the financial press which added credence to the Secretary's remarks by comparing the rates that banks charge to prime business customers with a money market rate in percentage point terms alone, without regard to other factors.

I have discussed the subject of interest rates many times before, so some of what follows will not seem new to regular readers of the Economic Report. However, I feel constrained to respond to these allegations, for they are misleading, to say the least. Let me tell you why I think interest rates are high, and whose responsibility it is to bring them down.

Bank Lending Spreads ...

Superficially, it does appear that the spread between the rates banks charge on money they lend and pay for money they attract has widened dramatically in recent years. In 1977, for example, little more than one percentage point separated key money market rates from the banks' lending charges on prime business loans. Today that spread is as high as three percentage points. However, because of the rising interest rate environment we have had in recent years, it is inaccurate to look at spreads in percentage point terms alone. This is because banks, like any other business, set their prices in relative terms compared with their costs, not absolute terms. Between 1977 and 1982 short-term interest rates about doubled. Obviously, charging the same absolute spread in 1982 as in 1977 would have resulted in a percentage markup only half as great. In relative terms, then, the spread between the prime rate and the banks' cost of funds did not increase as much as it seems.

But this is not all. For while the posted prime is an important benchmark rate, it does not accurately represent the interest rates that banks charge on many short-term loans. According to the Federal Reserve Board, the weighted-average interest rate on short-term commercial and industrial loans today is as much as one percentage point lower than the posted prime. This reflects the growing tendency of large, top-rated corporations to be able to negotiate rates below the posted prime because of their ability to access the domestic and international money markets, where rates are lower. Looking at banks' lending charges this way discloses that the average rate on short-term loans was not unusually high in 1982, when compared with money-market rates in either absolute or relative terms.

As for the banks' cost of funds, I would like to point out another misconception. This is that the latest interest rate on Federal funds, commercial paper, or certificates of deposit represents the average cost of funds to banks at a given moment in time. It does not, since banks obtain money from a variety of sources with maturities ranging from overnight to several years in duration. One must combine these sources into a blend, or weighted average cost of funds to get the true picture of a bank's money costs. If one does, one will find that these costs are even closer to the average rate charged on short-term business loans—both in absolute as well as in relative terms.

... Are Less Than They Seem

Even this does not tell the entire story. For a bank's interest cost structure reflects more than simply a spread between the average rate earned on earning assets (loans) and the average rate paid for interest-bearing funds. You see, spread is not the same as yield, which takes into account not only interest-bearing funds but interest-free sources as well, such as demand deposits. And in recent years, as a result of both deregulation and a change in corporate deposit habits, banks have seen a dramatic decline in the amount of interest-free funds available to them.

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At Manufacturers Hanover, the percentage of funds coming to us interest-free that we use to finance our assets has been cut in two since 1976, from nearly 20 percent then to only about 10 percent today. Add to this the deregulation of consumer deposits, which replaced interest-free checking accounts and low-interest savings accounts with NOW accounts, money market accounts and Super NOWs and you can see the addition of another sizable cost to the interest cost structure of the banking system. And the banks are not only relying more on interest bearing deposits, they have to make sure they are paying competitive rates, since these interest bearing deposits are becoming increasingly market-rate sensitive.

NET YIELD ON EARNING ASSETS AT 20 MONEY CENTER BANKS

Year	Earning Asset Yield	Interest Bearing Liabilities Cost	Interest Rate Spread	Cost of All Funds	Net Yield on Earning Assets
	(1)	(2)	1–2=(3)	(4)	1–4=(5)
1975	8.91%	6.76%	2.15%	5.43%	3.48%
1976	8.16	5.91	2.25	4.72	3.43
1977	8.13	5.87	2.26	4.75	3.38
1978	9.50	7.26	2.24	5.96	3.54
1979	11.81	9.82	1.99	8.26	3.55
1980	13.60	11.97	1.63	10.14	3.46
1981	16.11	14.67	1.44	12.72	3.39
1982*	14.82	12.93	1.89	11.20	3.63

*Average of first three quarters
Source: Robinson Humphrey/American Express Inc; MHT.

The bottom line is quite different from the top line. As you can see from the table, while there was a 45 basis point improvement last year in the interest rate spread at 20 money center banks, the figure that affects profits, net yield on earning assets, showed an improvement of only 24 basis points. And these are in absolute terms; in relative terms, on both the interest rate spread and net yield basis, the difference between what we charge and what we pay was lower in 1982 than seven years earlier!

Critics of bank lending charges might have more of a leg to stand on when they look at consumer lending rates. For unlike the prime rate and other lending rates to business, which have come down considerably from their recent peaks, consumer lending rates have hardly budged at all—and in some cases are higher today than one and two years ago.

Here, too, there is an explanation. For one thing, consumer loans tend to be smaller than business loans, thus involve more paperwork (loan applications, credit checks and so forth) per million dollars, for example, than a business loan. Obviously this is a cost which has to be factored into the price of the loan. And, unlike business loans, loans to consumers tend to be at fixed rates of interest for several years at a time. This means that a loan which is profitable when it is initially approved, may eventually become unprofitable if money costs rise above the return on the loan—as has been the case so many times in the past. There are greater risks involved in loans to consumers than to businesses so this must be factored into the cost of the loan. Until recently, most consumer lending operations were not profitable because of interest rate ceilings. These have been lifted in most states, suggesting that the high rates on some types of consumer loans may be just an immediate after-effect as these departments seek to make up for lost profitablity.

One thing must be remembered in discussing the banks' pricing policies. This is the fact that the banks are not the only source of funds for both individuals and business. What is more, the commercial banks may be losing ground to other companies in the financial services industry which suggests that bank loan pricing cannot get too far out of line with these other sources.

Interest Rates Are High ...

Let me turn from bank lending rates to interest rates in general. For in the final analysis, the banks can only squeeze their interest rate spreads so far in bringing down the cost of borrowing to business and consumers. If the cost of money, itself—in other words, the general level of interest rates in the money markets—is high, then there's no way that bank lending charges can get down low enough to satisfy the Administration, or anyone else, for that matter.

Therefore, it is necessary to consider why market rates of interest are still high—not only in nominal or quoted terms, but in real terms, when measured against the current rate of inflation. For it has been the high real rates of interest that have been largely responsible for slowing the economy. Indeed, when real interest rates hit 50-year highs between mid-1981 and mid-1982, they were subsequently followed by a rise in business failures to half-century highs which produced the worst recession since the 1930s.

Of course, real interest rates have come down somewhat from these half-century records. However, they are still well beyond the boundaries that both business and consumers have grown accustomed to over the last several decades. The December Economic Report offered the following explanation: "The greater volatility of both interest rates and the money supply following

the Federal Reserve's shift to monetarism three years ago seems to have added a 'volatility premium' to the level of interest rates besides the inflation and rent premiums, both of which had been embodied in interest rates for many years. In the summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a 'fear' premium.

"The markets got scared beginning in the summer of 1981 when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory. The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process—or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation."

... Because Budget Deficits ...

I would say that these fears are very much in evidence today. The volatility premium no doubt has shrunk because the Federal Reserve since July 1982 appears to be focusing more on managing interest rates and less on managing the quantity of money. Indeed, short-term interest rates have become extremely stable day-to-day —notwithstanding their precipitous decline last summer. But the fear premium is still very much in evidence. In the money markets, there is a fear of a renewed credit squeeze if the Federal Reserve once again becomes concerned over money supply growth and seeks to slow it down. And the bond markets are concerned about the higher rate of inflation that seems likely to arise sometime down the road if the Fed does *not* concern itself with money supply growth, and allows recent hefty rates of increase to continue.

Before you conclude that there is a Catch-22 here suggesting that interest rates are bound to rise one way or another, let me point out that they need not. However, this would require action by the Administration and the Congress. The key to lower interest rates deals with current and prospective borrowing by the Treasury to meet its huge, unprecedented budget deficits. No matter how you look at it, the deficit is far too large, given the state of our economy, the financial markets, and the availability of savings to finance them. Whether you compare the deficit with the gross national product, or total Federal borrowings with the supply of savings, you must conclude that we are in uncharted territory.

To make matters worse, the underlying imbalance between our spending programs and the revenue-generating capacity of the tax system at reasonable levels of employment (the structural deficit) promises to increase as fast as the cyclical portion of the deficit declines. This means that we cannot count very much on economic recovery to reduce the deficit and get the Federal government out of the way of the private sector in the competition for funds in the financial market place. The implication is that a new clash between government financial needs and the needs of business, homebuyers, farmers and consumers is on the horizon. Since the government is an insensitive borrower (it borrows what it needs, when it wants to, regardless of the cost), the financial markets, in anticipation of the higher interest rates that will result from this clash, are keeping interest rates high today in order to protect themselves against tomorrow.

In criticizing the banks for keeping interest rates high, the Administration is trying to deflect public opinion from its own economic mistakes. This year's budget document contains the same amazing revelation as last year's concerning the revenue impact of the Economic Recovery Tax Act (ERTA) of 1981. The Office of Management and Budget estimates that between 1982 and 1986, ERTA alone will cost the Federal government $609 billion in tax revenues. That's 72 percent of the $850 billion cumulative deficit that the Administration believes it will run during this time! The balance, I am sure, can easily be accounted for by the impact that these deficits had on the level of interest rates and the subsequent recession that these high interest rates caused. High interest rates, of course, added to government spending and subtracted from government tax revenues, while the recession cut further into Federal tax revenues while increasing Federal expenditures on unemployment insurance, and so forth.

... Continue To Grow

The time has come for the Administration to stop blaming others for its misdeeds and start looking at its own policies. It should be clear by now that the original plan to boost government revenues by cutting taxes has not worked and will not work. It should also be obvious that using lower revenues as a club to force Congress to cut spending has only a limited effect. If you don't believe me, look at the record: With only two budget surpluses in the past quarter of a century, when did lack of revenues ever constrain the government from spending?

Bankers may indeed be very responsible people—but it is the Administration that is responsible for keeping interest rates high, not us. M

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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APRIL 1983

The Doughnut or the Hole?

Now that inflation has cooled, national attention is focusing on unemployment. The jobless rate has been above ten percent since September, 1982—setting a postwar high in the process. It has been eight percent or higher in every month since October 1981 and April 1980 was the last time it was below seven percent. By contrast, the unemployment rate averaged less than seven percent from 1976 through 1981. It has averaged 5.4 percent over the entire postwar era—and was no higher than four percent every single month from December 1965 through January 1970.

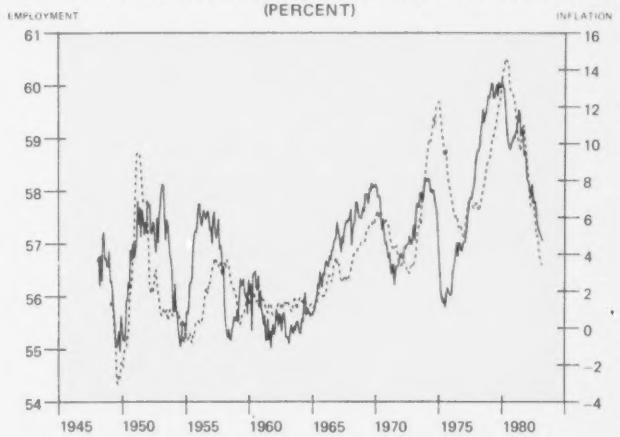
Not surprisingly, this trend has generated much concern. In Washington, a bill was recently signed into law by the President which would create nearly one million jobs at a cost of close to $5 billion. Elsewhere, there is more and more talk about the U.S. facing a period of prolonged high rates of unemployment, and more specifically, of families, cities and regions no longer expecting much improvement in their economic fortunes because of the changed nature of our economy.

Today's Employment Levels...

While these unemployment trends are most unfortunate, we should not overlook developments on the other side of the coin: Employment. For even while the jobless rate continues to run close to its postwar highs with the number of unemployed up almost 50 percent in two years, the number of people with jobs is only two percent (or 1.9 million) below its all-time high set in April, 1981. What is more, the employment rate (the number of people employed divided by the over-16 population) is about equal to its postwar average of 57 percent. This is down from the record 60 percent reached during 1979, when the unemployment rate averaged less than six percent. However, it does equal the 57 percent rate posted in January 1977—when the unemployment rate was 7.5 percent.

Without minimizing the relevance of the unemployment statistics (especially to the unemployed) I would like to make a few points about employment. First, the employment figures are extremely important to the state of the economy, perhaps even more so than the unemployment numbers. There are several reasons for this. For one thing, statistically, the employment numbers are

CHART I
EMPLOYMENT RATE (LINE) VS. INFLATION RATE (DOT)
(PERCENT)



more reliable than the unemployment numbers. Even with today's high jobless totals, the employment numbers are nearly nine times the size of the unemployment figures, suggesting more possibility for sampling error in measurements of unemployment. Even more important, there are conceptual problems regarding exactly who is unemployed. Besides those people who lose jobs, the unemployed can include those who would like to have jobs, regardless of how seriously they search for work or whether they are the primary support of their households. The employment numbers, on the other hand, constitute a more precise concept: Either you are working or you are not.

Those who are working, of course, are those who earn the bulk of the nation's personal incomes. Last year income earned by people working for themselves or for others accounted for seven out of every ten personal

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income dollars. Since consumer spending accounts for two-thirds of the GNP, you can see where the employment statistics have an important role to play: Those who don't work don't have much to spend.

TABLE I

CIVILIAN LABOR FORCE PARTICIPATION RATE

(Percent)

Year	Total	Males	Females
1947	58.3	86.4	31.8
1964	58.7	81.0	38.7
1982	64.0	76.6	52.6

Source: Department of Labor, Bureau of Labor Statistics

Right now, with the economy barely emerging from recession, more spending is clearly desirable. However, there have been times in the past when people were seeking to spend more than there were goods available for them to buy. This led to inflation. Even though it is quiescent now, a number of economists have begun to express concern that inflation is about to worsen. They base this on recent developments in money supply growth which, admittedly, has been quite rapid. However, it takes time before money growth trends surface in price trends. A more immediate explanation of inflation can be found in the employoment rate. As you can see from Chart I, it is possible to associate the percentage of the population employed with the rate of inflation—at least in a modest way. When the employment rate rises the inflation rate tends to rise, too. And as you can see from the chart, it does not take long before this happens. But as you can also see from the chart, when the employment rate falls the rate of inflation falls as well.

...Suggest Neither Imminent Inflation...

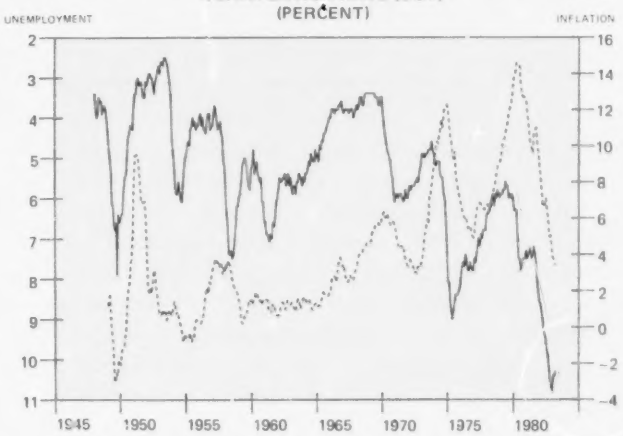
The employment rate also provides a better explanation of inflation than the unemployment rate. This is not just a recent development, either. As you can see from Chart II the unemployment rate does not bear a close relationship to the rate of inflation even though logic would suggest there might be one. Most people believe that inflation results from an overheated economy, where too much demand pushes up wages and prices. A recession is said to remove some of this pressure as idled workers and excess capacity reduce the appetite of labor for wage increases and business for price increases.

The idea that there is such a trade-off between the inflation rate and the unemployment rate goes back to work first done by A.W. Phillips of the London School of Economics. He plotted rates of unemployment and increase in wages for Britain from the 1860s to the 1950s. Wage inflation was considered to be a good stand-in for price inflation since wages generally accounted for as much as three-quarters of the final cost of goods produced. Phillips showed that periods with high unemployment had relatively low inflation rates, while years with low unemployment had relatively high inflation rates.

For this trade-off to have relevance, two factors should be present. The first is that the rate of participation in the labor force must be constant, while the second is that the relative importance of the factors of production should remain the same. As you know, neither has been the case in the United States. Most of the inflationary forces of recent years, such as energy, food and interest rates were not particularly related to changes in employment and unemployment. Even more important is the fact that the labor force participation rate (total labor force as a percent of the noninstitutional population) has not held steady but has increased dramatically. This has caused the jobless rate many times to reflect more people looking for work, rather than just fewer jobs alone.

It wasn't always this way. During the first 20 years of the postwar era, labor force growth roughly paralleled the increase in the population. In other words—the rate of entry into the labor force by people as they turned working age was constant, and, once they reached a certain age level and had not decided to look for work, they remained out of the labor market. In this environment, it was appropriate to place great emphasis on the

CHART II
UNEMPLOYMENT RATE, INVERTED SCALE (LINE)
VS. INFLATION RATE (DOT)
(PERCENT)

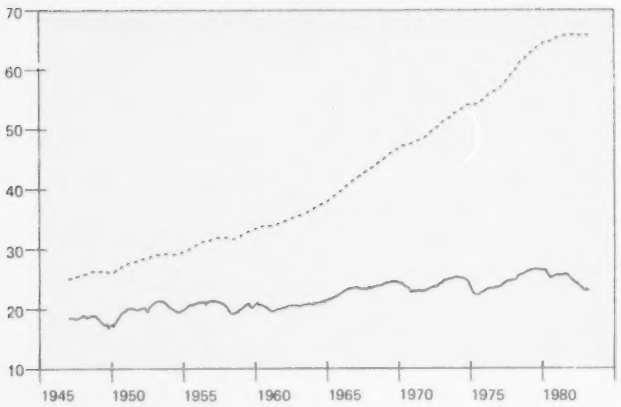


unemployment rate both as a reliable indicator of the condition of the labor market and (in an inverse way) as a good measure of inflation pressures.

Since the mid 1960s attitudes toward job holding have changed. I guess it started around the time the Vietnam

War escalated, causing large numbers of males to be drafted into the military. As was the case during World War II, their positions in the civilian labor force were filled, at least in part, by women, many of whom found themselves working for the first time. The rise of the Women's Liberation movement further encouraged women to remain in the work force as a means of showing their "independence." Other factors that contributed to an increased incidence of women working included a rising divorce rate and, in the late 1970s, the spiraling rate of inflation. The ending of the draft following the ending of the war allowed large numbers of teenagers to seek work, rather than stay in school.

CHART III
GOODS-PRODUCING EMPLOYMENT (LINE)
VS. SERVICE-PRODUCING EMPLOYMENT (DOT)
(THOUSANDS)



The net result is that the one-income family has become a thing of the past. The average family now has at least two people working, and, in some instances, three. Reflecting a jump in the female participation rate to 52½ percent last year from 39 percent in 1964 and 32 percent in 1947, the overall labor force participation rate reached 64 percent in 1982. In 1964 it was 58.7 percent—little different from the 58.3 percent of 1947. The participation rate of males in the labor force has declined somewhat over the years. In 1947 86½ percent of males were in the work force compared with 81 percent by 1964 and 76½ percent last year (see Table I). Some of this might trace to the increased incidence of females in the work force as some males have elected to stay home and let their wives work. However, some undoubtedly traces to the changed structure of the economy; jobs that are more likely to be filled by males (those requiring physical labor) have been eliminated due to a variety of factors including automation, foreign competition or, simply, a decline in the need for the products produced by certain industries.

A good example is the manufacturing sector. While manufacturing occupies about the same share of the real economy today as it did more than 30 years ago (some 24 percent), the percentage of employment in the manufacturing sector has dropped dramatically. In 1950 manufacturing could claim about one-third of all those employed; today it accounts for little more than one-fifth. The goods producing sector in general has seen its share of employment fall from 41 percent in 1950 to 26 percent today. By contrast, industries considered to be service producing have seen their share of employment rise from 59 percent in 1950 to 74 percent today. Services in particular about doubled their share from 11.9 percent in 1950 to nearly 22 percent in 1982 (see Table II).

A glance at the payroll employment statistics shows that, if anything, these trends accelerated during the past recession. Total nonagricultural payroll employment today is some 2½ million below its peak of July, 1981. Within this category, goods producing

TABLE II

SHARE OF REAL GROSS NATIONAL PRODUCT AND EMPLOYMENT BY SELECTED CATEGORIES 1950 TO DATE

	1950	1960	1970	1980	Latest Data*
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%
GOODS PRODUCING					
% of GNP	37.5%	35.7%	33.9%	31.6%	31.7%
% of Employment	41.0	37.7	33.3	28.4	26.0
of which:					
Manufacturing					
% of GNP	24.5	23.3	24.1	23.8	23.9
% of Employment	33.7	31.0	27.3	22.4	20.5
of which:					
Durables					
% of GNP	14.6	13.7	14.3	14.2	14.3
% of Employment	17.9	17.5	15.8	13.5	11.9
Nondurables					
% of GNP	9.9	9.6	9.8	9.6	9.6
% of Employment	15.8	13.5	11.5	9.0	8.6
SERVICE PRODUCING					
% of GNP	61.3	63.6	65.1	67.0	67.3
% of Employment	59.0	62.3	66.7	71.6	74.0
of which:					
Services					
% of GNP	11.1	11.3	11.7	12.8	13.1
% of Employment	11.9	13.6	16.3	19.8	21.7
Wholesale & Retail Trade					
% of GNP	16.4	15.9	16.2	16.5	16.7
% of Employment	20.8	21.0	21.2	22.5	23.0
Governments (All Levels)					
% of GNP	14.1	14.6	14.1	12.0	11.9
% of Employment	13.3	15.4	17.7	18.0	17.7

*Latest data for employment is first-quarter 1983, for GNP, 1981
Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; MHT

employment, which today accounts for about one-fourth of all nonagricultural payroll employment, caused all of the decline since July 1981 and then some. By contrast, service-producing employment increased by about 150,000 (Chart III). The manufacturing sector alone saw its payrolls shrink by over 2.1 million while service industries increased their payrolls by 678,000.

...Nor Continued Recession

What all of this means is that, in looking at the labor force figures, one should look at the doughnut as well as the hole: employment besides unemployment. If one does, one will find as a top-line conclusion that the number of jobs has not shrunk much during the past recession, thus the ability of the population at large to support itself is no worse than the postwar average—notwithstanding the unusually high rate of unemployment. Within the employment totals, however, there are changes which reflect the shifts in the economy that are apparently taking place away from manufacturing in particular (and goods producing in general) to service producing industries. While this is causing some people to face a permanent loss of jobs unless they learn new skills, it is providing openings for others who are more interested in working nowadays than their older siblings or parents might have been some years ago.

There does not seem to be a quantitative trade-off between inflation and unemployment. Indeed, if there is a relationship between the two, it is not negative, but positive: The spiraling inflation of the late 1970s caused second and third workers from households to enter the labor force seeking work to help the breadwinner make ends meet. While the reduction in inflation could, by this line of reasoning, enable some of these newcomers to withdraw from the labor force thus allowing the unemployment rate to more accurately reflect the creation of jobs, the extremely long period of time during which the U.S. has been in an economic slump, combined with the 40 year-high rate of unemployment, might very well encourage these secondary workers to remain in the labor force if they believe that jobs will be more plentiful, in order to help their own households recover. If this were to happen, the unemployment rate would stay high well into the economic recovery.

This is why I would place greater emphasis on the employment numbers, both as a means of analyzing the state of the economy as well as for policy recommendations. What I am referring to, of course, is the effects that employment seems to have on inflation. While factors of production do change, the employment/population ratio is a good measure of the degree to which the economy is being stretched to its limits or not as the case may be. Therefore, policymakers should watch this measure very closely as they attempt to reduce unemployment.

Right now, because of the sharp drop in the employment rate, there does not seem to be much danger of inflation accelerating—trends in money growth notwithstanding. However, once the employment rate turns up, the time will draw near to keep a watch for inflation. M

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
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Current Issues

Over the next few weeks, policymakers here and abroad will be grappling with a number of economic issues. How these are resolved will have significant bearing—not only on the outlook for the near-term, but, conceivably, for many years into the future as well. At present, there is the question of the Federal government's budget, and how much red ink it will run. At the end of this month, there is the meeting of the principal industrial nations of the Free World in which a wide variety of international and domestic items will be discussed, among them, foreign exchange rates. And in July, the House of Representatives Committee on Banking, Finance and Urban Affairs plans to hold hearings reviewing the five-year record of monetary policy under the Humphrey-Hawkins Act. What follows is a brief discussion of these agenda items, which, I hope, will help the reader put them in proper perspective.

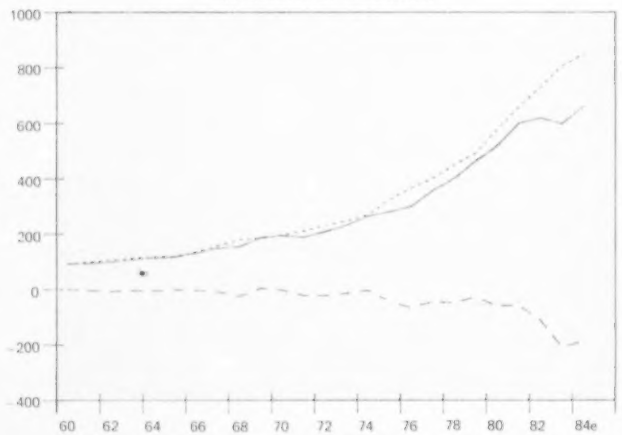
The Deficit Question

The inability of Congress and the Administration to agree on a budget resolution reflects more than differences over spending priorities. A country as big as ours, with so many regional interests, is bound to have differences of opinion, when it comes to dividing up the Federal budget. In the past these differences were resolved—although not without sizable growth in government spending. The political process being what it is, in most years of the postwar era the Congress failed to vote enough revenues to match these expenditures, so the budget tended to be in the red.

As readers of this Report know by now, I am no fan of budget deficits. Yet, the economy managed to grow and prosper throughout the postwar era even though Washington ran about four budget deficits for every budget surplus. This is because these deficits were relatively small, compared with the size of the economy, the financial markets, savings, and so forth.

All this changed starting in 1981. It was then that the Economic Recovery Tax Act (ERTA) was passed. It called for an across-the-board reduction in individual income tax rates and other reductions in individual income taxes; the annual adjustment of the zero bracket amount, the personal exemption, and individual income tax brackets for inflation beginning in 1985; and the accelerated cost recovery of capital expenditures. Although this was passed at a time when the budget was in deep deficit (the fiscal year 1980 deficit of $59.6 billion was less than $7 billion shy of the all-time record set in 1976, while FY81's deficit amounted to $58 billion), it was sold to the Congress and the American people on

FEDERAL BUDGET RECEIPTS (LINE), OUTLAYS (DOT)
AND BUDGET SURPLUS OR DEFICIT (DASH)
(BILLIONS OF DOLLARS)



Sources: Department of the Treasury; Office of Management and Budget

the basis that it would generate more tax revenues by encouraging people to work harder, invest more and come out from the "underground" economy. As you can see from the chart, this did not work. There was a dramatic falloff in revenues starting in 1981, immediately upon passage of ERTA. And, as I have noted in the past, the Administration now admits that it will lose $609 billion from 1982 through 1986 as a result of ERTA.

What amazes me is that, in the face of these developments, the Administration has been able to shift the focus of public attention away from the revenue side toward the spending side—and that means the Congress. Now I am not going to say that government spending

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has not risen rapidly in recent years. Nor am I about to defend every item in the expenditure budget—nondefense or defense. However, I do think several points are worth mentioning. First, the notion that defense spending should be put on a par with nondefense spending by comparing it with GNP gives me a great deal of trouble. I cannot see where the size of our economy should have anything to do with the size of defense spending. How much money needs to be allocated to defense should be determined by such factors as world tensions, our military preparedness, as well as the state and cost of military technology. But the size of our economy *does* have something to do with the size of nondefense spending, since these are expenditures for goods and services that go largely to U.S. citizens.

There is no denying that there has been significant growth in nondefense spending over the past thirty years. It is also true that a lot of this growth has come since the 1970s, with the enactment of the so-called "entitlement" programs introduced or modified around the turn of that decade. In such programs, the basic legislation does not appropriate a fixed amount of money for a particular purpose, but establishes rules that define who is eligible for benefits and the nature and amount of benefits for which each person is eligible. Funds must subsequently be appropriated to pay for these benefits, and the tremendous buying power that these benefits represented has caused the cost of these programs to rise, and with it the necessity for more and more Federal money.

Those who complain that this is adding unnecessarily to the size of government might be right, but the way to go about reducing it is not to deprive government of revenues and then ask the Congress to respond by curtailing spending. As I have noted in the past, with only two budget surpluses in the past 25 years, when did lack of revenues ever constrain the government from spending? Rather, the whole question may have to be put to a national referendum. Since politicians find it very difficult to do anything that will jeopardize the support of their constituents, the time may have come to ask the electorate what its preferences are. Barring that, we might want to consider the words of the immortal Will Rogers, who once said: "We will never get anywhere with our finances, 'till we pass a law saying that every time we appropriate something, we got to pass another bill along with it stating where the money is coming from."

But this is for the future; for now, it is imperative that revenues be put back on track. The Administration, itself, admits that even under the best of circumstances the budget will still be in deficit by close to $200 billion in 1985 and nearly $150 billion in 1986. There is no way that these deficits will be able to be financed in the context of continued recovery of the private sector, low interest rates and low rates of inflation. So if this recovery is to last beyond 1984, Washington's budget deficits must be shrunk as soon as possible. Government spending ought to be curtailed, to be sure—but government revenues must be restored in the meantime.

Floating Exchange Rates

Toward the end of last year, at a meeting originally scheduled to deal with an increase in lending power for the International Monetary Fund, the U.S. suggested that the agenda also include a discussion of the much broader issue of changes in the world's monetary system. Specific reference was made to foreign exchange rates, which besides being volatile, have resulted in currencies not being valued at appropriate levels relative to one another. The dollar is a good example, since most economists believe it is overvalued against the currencies of our trading partners. In turn, this has had a significant impact on the U.S. economy by curbing our exports and encouraging imports. One way to measure this is to compare the change in net exports (exports minus imports) over the past six calendar quarters with the change in the gross national product, both adjusted for inflation. Looked at this way, net exports, which amounted to only two percent of the real GNP during this time, accounted for about 70 percent of its decline!

The ten-year old floating exchange rate system has had its boosters and detractors over the years. It is generally agreed that no system of fixed exchange rates could have survived the significant jumps in oil prices of the 1970s, their effect on inflation, currency flows and world trade. And since speculators no longer had fixed currency targets to shoot at, monetary crises, such as were common in the closing days of fixed exchange rates, have largely been avoided. However, in their place has appeared day-to-day currency volatility, spawning persistent distortions in exchange rates, generating a mood of uncertainty that may have injured world trade and added a premium onto interest rates everywhere. As Paul Volcker, Chairman of the Federal Reserve System, recently said: "While some or most of the major swings (in exchange rates) have had a rationale in terms of divergencies in inflation rates, competitive positions, or structural changes, the extent and timing of some of the changes have, even in retrospect, been difficult to explain." While suggesting that intervention by central banks is a limited tool that cannot by itself alter market forces, Chairman Volcker was hopeful of being able to dampen extreme exchange rate movements, saying: "We can constructively do something to help stabilize exchange rates within the general framework of the floating system."

As I see it, several questions must be addressed, in order for this discussion to be meaningful. The first is: Are we talking about only dampening daily and weekly movements of currencies against one another, or will there be other objectives, such as attempting to move the value of currencies in a direction which may seem

economically prudent but against what the markets judge should be the case? Will these exchange rate objectives be announced in advance? How long and how serious a commitment will there be? And last, but by no means least, will attempts to harmonize exchange rates be accompanied by harmonious economic policies?

Your guess is as good as mine as to how the first three questions will be answered, but one point seems germane at this time. This is a widespread belief that, for the first time in recent memory, the major industrial countries of the West now have the same economic objectives, thus raising the possibility that their economic policies *can* be coordinated. All of us are either in or just emerging from severe economic recession. At the same time, interest rates are still too high, so another mutual objective would seem to be to reduce the cost of money. And while no country should ever let down its guard completely against the possibility of renewed inflation, the facts are that the U.S. and most of its trading partners have made dramatic progress in slowing the rate of inflation over the past few years.

Since the current economic environment dictates that the U.S. and its major trading partners should now favor fighting unemployment and restoring economic growth, if we are to ever take a stab at reducing exchange rate volatility, now might be the most appropriate time. However, intervention cannot take the place of economic policy coordination as a means of *fundamentally* dampening swings in currency values. And needless to say, economic policy coordination requires just that: An agreement on the part of the Free World's trading partners to pursue similar domestic policies—in this instance, designed to keep inflation under control while stimulating economic growth. I know it is asking a lot for nations to give up some degree of economic sovereignty in order to create a more viable international monetary system. But like the discussion regarding the Federal budget, there must be compromise; not everyone can have his way.

Monetary Policy

Although the economy is clearly on the upswing and this year is *not* an election year, the Congress, nevertheless, intends to take a very close look at monetary policy this summer. There are several reasons for this. For one thing, the four-year term of Federal Reserve Chairman Paul Volcker expires in August and, as you might imagine, there is much interest on the Potomac in who his successor might be—if there is one. Second, although interest rates have come down substantially from their year-ago peaks, they are still high, when compared with the rate of inflation, and when they are not blaming the banks for this (Economic Report—March, 1983), the politicians tend to blame the Fed. Finally, it 's been five years since Congress passed the Humphrey-Hawkins Act, which, among other things, required the Fed to report to the Congress its targets for monetary growth at semiannual "oversight" hearings.

Any examination of monetary policy should deal with several questions. For one thing, can the money supply be identified with sufficient precision to allow its use as an objective for Fed policy—not to mention as a proxy for economic performance? From here, it would seem that the answer is; "not as much as previously." This is because recent deposit innovations and financial deregulation have blurred the conception of "money." If the purpose of establishing a certain rate of growth for the money supply is to ensure that there is neither too much nor too little liquidity in the economy, then the Fed may be having a hard time determining just what is liquidity. This is because of the rise of money market mutual funds, money market accounts at commercial banks and thrifts, negotiable orders of withdrawal (NOW) and Super NOW accounts—along with a greater awareness and sophistication on the part of the public as to the availability of such forms of near-money as certificates of deposit, Treasury securities, and so forth. As a result, if there ever was a definable monetary aggregate with a stable relationship to GNP, inflation, and unemployment it is less apparent today.

Reference is also made to the velocity of money. This is the rate at which money changes hands, and is obtained after the fact by dividing the dollar value of the gross national product by the money supply. Trends in velocity have neither been stable nor predictable over short periods of time, but velocity has apparently been declining for a year and a half—the longest period in postwar economic history. The question that faces the Federal Reserve at this point is how much longer will this decline last, and what should be done once velocity increases. For the Fed had to pump out significant sums of money starting in the middle of last year in order to get interest rates down and the economy growing again. That money is still in circulation, and has the potential to produce a new round of inflation, if people should decide to spend it faster.

In the process of engineering the decline in interest rates in 1982, the Federal Reserve, besides pointing to the "breakdown" in velocity trends, had to convince the financial markets that the monetary aggregates were not as believable as before. The Fed managed to do this by pointing to such developments as the maturing All-Savers accounts, the new money market accounts that banks and thrifts were allowed to offer, and other factors. Whether or not these developments reduced the reliability of the monetary aggregates remains to be seen, but they do reveal that the Fed has been following an eclectic policy for almost a year, rather than one focusing strictly on the money supply or similar monetary variables. In my view, this was—and still is—the appropriate policy for the Fed to follow. Reliance on the monetary aggregates alone is useful mainly during periods when inflation is the Fed's primary target; it doesn't always follow that achieving